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SECURITIES OFFERINGS

SEC Issues Warning to Lawyers on ICOs




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Over the last several months, the SEC has intensified its threats to so-called ''gatekeepers,'' especially in the area of initial coin offerings (''ICOs'') and cryptocurrencies. In testimony on Tuesday, February 6, 2018 before the Senate Committee on Banking, Housing, and Urban Affairs, SEC Chairman Jay Clayton reminded gatekeepers—including lawyers—that the SEC is laser-focused on them when they advise clients on ICOs. Clayton's testimony was his latest in a series of warnings to lawyers involved in structuring ICOs that the SEC is on ''high alert'' and may charge them with securities law violations if they do not ''do better'' in performing their job as gatekeepers for the securities industry. While the SEC has long sought to hold accountable lawyers whom it believes have fallen short of their professional obligations, Clayton's recent warnings go far beyond those of his predecessors.

While many entrepreneurs—and their lawyers—may view ICOs as a decentralized and largely unregulated means of raising capital, the SEC has essentially adopted a rebuttable presumption that ICO tokens are securities that must comply with the registration requirements of the securities laws. In his recent remarks, Clayton admonished lawyers that they will be held accountable not only for deliberately advising their clients on how to use ICOs to avoid securities registration requirements (which is not surprising), but—more importantly—for providing perfunctory and potentially negligent '' 'it depends' equivocal advice'' about whether an ICO is a securities offering.

Clayton's comments reflect an important shift in the SEC's approach. It has adjusted its focus from lawyers as gatekeepers with the responsibility to advise their clients on the securities laws, to lawyers (when they counsel clients on ICOs) as primary actors who must ensure that these new offerings comply with the securities registration requirements or the private placement rules, or face heightened scrutiny. Lawyers would be wise to listen carefully to Clayton's admonitions.

Why the Focus on ICOs?

In an ICO, an entity offers participants unique, virtual ''tokens'' in exchange for either fiat currency or cryptocurrency, such as Bitcoin. Tokens are recorded on a distributed ledger—called a blockchain—and are theoretically unalterable.

Tokens come in different forms and provide investors with different rights. Equity or security tokens represent shares in an entity and imply a *pro rata* form of ownership and control. Utility tokens provide access to or use of a company's platform, product, or service. Asset tokens represent a physical asset or product, such as gold, and are often difficult to subdivide.

To take a simple example, imagine that a company plans to hold an ICO to raise funds to build a bookstore. The ICO could offer tokens that represent a share in the bookstore company itself (equity or security tokens), to-

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kens that could be used as gift certificates for books once the bookstore is operational (utility tokens), or tokens that represent the actual books themselves (asset tokens).

Typically, an ICO is announced through online channels. The ICO sponsor provides online access to a white paper that describes the project and the terms of the ICO—and effectively serves as an offering memo. When the ICO launches, subscribers transfer cryptocurrency (or credit card information) to the sponsor's digital wallet; in return, the sponsor distributes tokens to subscribers' digital wallets. Often tokens can be traded for cryptocurrency or fiat currency in a secondary market. In 2017, ICOs raised approximately $4 billion.

Given the significant amount of capital raised through ICOs, it is no surprise that the SEC and other regulators have focused their recent oversight efforts on these offerings. Although the SEC has recognized that ICOs can be an effective fundraising mechanism, it has also warned investors that, in the absence of a regulated exchange, these offerings come with significant risks because of the lack of disclosure, market volatility, and the potential for manipulation and fraud. Presumably, it will take time and careful scrutiny for the SEC to determine how best to protect investors through regulatory action, including the promulgation of ICO-specific regulations. In the meantime, the SEC is targeting lawyers who knowingly or unwittingly assist ICO issuers who circumvent the securities registration requirements.

The SEC's Scrutiny of ICOs

The SEC's response to two recent ICOs reveals its intention to monitor these offerings closely. On July 25, 2017, the SEC issued a Report of Investigation (the "DAO Report") concluding that the 1.15 billion tokens offered by the virtual entity "The DAO" were securities that should have been—but were not—registered with the SEC.

In concluding that the DAO tokens were securities, the SEC applied the test established by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and examined whether purchasers of the ICO (i) invested money or valuable goods or services; (ii) were investing in a common enterprise; (iii) had a reasonable expectation of earning profits; and (iv) earned profits from the ICO that were derived from the efforts of others. In the DAO Report, the SEC reasoned that the ICO constituted a securities offering because the subscribers (i) made payments in a cryptocurrency (Ether) that constituted investments of money; (ii) invested in a common enterprise—The DAO; (iii) reasonably expected to profit from projects funded by The DAO; and (iv) relied on the efforts of The DAO's founders and "curators" to manage The DAO and suggest profitable project proposals. Importantly, the SEC noted that whether any ICO constitutes a securities offering depends on the "particular facts and circumstances of each offering" and emphasized that not all tokens offered through ICOs will be considered securities.

In December 2017, the SEC brought (and settled) its first enforcement action against an ICO issuer, Munchee, for failure to comply with the securities registration requirements. Munchee was a California business that launched an ICO for so-called "MUN" tokens in order to raise approximately $15 million to improve its iPhone restaurant review application. In its pre-ICO white paper, Munchee announced that it had performed a "*Howey* analysis" and concluded that the MUN tokens were utility tokens that did not implicate federal securities laws.

The SEC disagreed and found that the MUN tokens were securities under the *Howey* test. Focusing on the ICO's substance rather than its form, the SEC noted that Munchee's founders had created a reasonable expectation that the tokens' value would increase due to the company's efforts to improve its application, and that investors could expect to profit by selling their tokens in the secondary market.

The SEC's Focus on Lawyers

Amid the developing state of the law on ICOs, Clayton has made several statements emphasizing the responsibility of lawyers in this area. Clayton's comments echo those of several former SEC leaders who have increased the SEC's focus on individual gatekeepers—including lawyers.

But Clayton's recent comments about lawyers who advise clients on ICOs are striking for two reasons. First, in a speech on December 11, 2017, Clayton essentially articulated a rebuttable presumption that an ICO is a security. He cautioned lawyers not to "elevate form over substance" and explained that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security." Thus, the SEC has put the onus on issuers—and their lawyers—to engage in a highly fact-intensive *Howey* analysis to clear the high hurdle of showing that offered tokens somehow are not securities. Notably, in Clayton's view, to date nobody has done this successfully. As he told the Senate Committee, "every ICO I have seen is a security."

Second, in a speech on January 22, 2018, Clayton warned lawyers that if they give any legal advice to clients who engage in ICOs, they will be held responsible should their clients violate the securities registration requirements. Notably, Clayton explained that in addition to lawyers who deliberately assist their clients in structuring offerings to avoid registration requirements, the SEC is also focused on lawyers who "appear to have taken a step back from the key issues" and "provide the 'it depends' equivocal advice, rather than counseling their clients that the product they are promoting likely is a security." This latter group of lawyers, according to Clayton, will be investigated, and they may become the targets of enforcement proceedings for neglecting to research and examine the critical issue of whether the offering is subject to the securities laws.

Clayton renewed his admonishment to lawyers in a joint op-ed with CFTC Chairman J. Christopher Giancarlo published in the Wall Street Journal on January 24, 2018. The two regulatory leaders warned "[m]arket participants, including lawyers" that they "should be aware that [the SEC and the CFTC] are disturbed by many examples of form being elevated over substance, with form-based arguments depriving investors of mandatory protections."

Most recently, during his Senate Committee testimony on February 6, 2018, Clayton again stressed that the SEC is "counting on" gatekeepers, including lawyers, "to do their job—and I've made that clear." When Senator Elizabeth Warren asked him why no ICOs had

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registered with the SEC, Clayton put the blame squarely on lawyers and other gatekeepers:

> I don't think the gatekeepers that we rely on to assist us in making sure our securities laws are followed have done their job. We've made it clear what the law is . . . . And folks somehow got comfortable that this was new and that it was okay and it was not a security, it was just some other way to raise money. Well, I disagree with that.

Recommendations for Lawyers Advising on ICOs

While the SEC's recent guidance makes clear that lawyers who advise clients on ICOs must proceed with extreme caution, it also suggests a few ways to navigate these challenges.

First, lawyers advising clients on potential ICOs must begin with the presumption that registration is required. To overcome that presumption, lawyers will need to be able to point to specific facts about the offering that set it apart from all others the SEC has analyzed to date.

Second, lawyers must actively analyze the factors under the *Howey* test and focus on the substance of the transaction, not its form. In performing this analysis, lawyers should pay particular attention to whether the issuer is promoting the token for its value on the secondary market, and should carefully examine—and indeed challenge—the issuer's representations that its token does not qualify as a security.

Third, and perhaps most importantly, lawyers should confer with regulators. The SEC has repeatedly encouraged market participants to contact SEC Staff with questions about the application of the federal securities laws. Indeed, the SEC has created an email address—FinTech@sec.gov—for this sole purpose. Similarly, the CFTC has launched an initiative and provided an email address— LabCFTC@cftc.gov—to facilitate dialogue with market participants. If a lawyer has a *bona fide* reason to be uncertain and genuinely is left with an ''it depends'' conclusion as to whether an ICO's substantive characteristics rebut the presumption that the token is a security, the lawyer should engage with the regulators rather than risk SEC scrutiny.

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